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SUBJECT: ITALIAN EXPORTERS FACE DIFFICULTY WITH STRONGER
EURO, BUT LONG-TERM EFFECTS MAY BE LIMITED

1. (U) Summary: Italian exports, traditionally vulnerable to exchange rate fluctuations, are being hit by the Euro's appreciation versus the dollar. Exports to Italy's third most important market, the United States, are down eight percent on a 12-month year to year basis. In addition to the Euro's appreciation versus the dollar, two other factors cast a pall over Italian exporters: Germany, Italy's largest export market, is in serious economic trouble, and SARS has suppressed consumer demand in Asia. One positive aspect of a depreciated dollar: the price of raw materials and oil, generally dollar-denominated, should fall, indirectly affecting the price of exports of manufactured goods. Experts predict that long-term effects on Italian exports may be limited, as long as the Euro remains stable with regard to other major currencies and the dollar does not drop much further. End-summary

The Euro's Value

2. (U) The Euro reached its highest level ever against the U.S. dollar on May 27, with a rate of USD 1.1935/Euro. Overall, the Euro is up against the dollar by more than 13 percent for the year and 30 percent over one year ago. The Euro has strengthened, to a lesser extent, against the British pound (11 percent through end-May 2003 and 14 percent over one year ago), and the Japanese yen (11 percent through end-May 2003 and 20 percent over one year ago).

Effect on Italian Exports

3. (U) Italy has an export-led economy, with the United States representing the third largest foreign market for Italian exports. Italian exports have traditionally been highly susceptible to exchange rate fluctuations. Some leading Italian economists, including Central Bank Governor Antonio Fazio and Enrico Giovannini, an economist at the OECD, argue that Italy's exporters are even more susceptible than their European counterparts to currency fluctuations. In his annual report on May 31, Fazio argued that the composition of Italian exports makes them highly vulnerable to import price trends. Italian exports, he pointed out, are specialized in furniture, leather products and non-mineral metals manufacturing. Consumer demand for such high-end consumer products, he contended, is particularly influenced by the import price.

4. (U) Foreign trade with non-EU countries accounts for 47 percent of Italy's total foreign trade. Clothing exports to non-EU markets represent 53.6 percent of total exports of clothing, of which 15.1 percent go to the U.S. Separately, footwear exports to non-EU countries account for 42.2 percent of overall exports of footwear, of which 18.5 percent go to the U.S. Of textile manufacturing machinery, 69.9 percent of total exports of this category go to non-EU countries, 12 percent of which are to the American market. The U.S. also is the primary export market for the furniture sector.

Latest Data

5. (U) On May 22, a leading economic think tank, Istat, released data through April of Italy's foreign trade with non-EU countries. The data showed an E956 million deficit in the first four months of the year. Exports grew only 0.2 percent from April 2002 to April 2003, while imports grew 2.6 percent. The strengthening of the Euro had an immediate impact on Italy's exports to the U.S., which decreased 8.8 percent from April 2002 to April 2003. In contrast, Italian exports to China grew by 23.2

percent from April 2002 to April 2003 and by 26.1 percent from the period January-April 2002 to the same period

this year. SARS, however, may show suppressed consumer demand in Asia in later statistics.

Some good may come

16. (U) According to Antonio Sagnotti, a researcher at one of Italy's leading banks, Banca Nazionale di Lavoro, Italian exports to the United States will continue to fall as a result of the strengthened Euro, but also as a result of weak American consumer demands overall. Sagnotti is optimistic, however, that the medium-range effect of a strengthened Euro will be limited. In contrast to the Central Bank Governor, he does not believe Italian exports are particularly vulnerable to exchange rate fluctuations. He argued that the demand for Italian exports would not shrink significantly as long as the Euro/Dollar exchange rate does not exceed .80 Eurocents/one dollar. Demand for high-end consumer goods, of which many Italian exports are, remains stable as long as there is only a 10-20 percent fluctuation in exchange rate values, he contended. Sagnotti expects only a modest decline in Italian exports to the U.S. this year, predicting that a recovery of U.S. domestic demand in the second half of the year will offset some of the price increases caused by the Euro's appreciation.

17. (U) Some leading economists see an upside to a stronger Euro vis--vis the dollar. Minister of European Union Affairs, Rocco Buttiglione, recently commented that a strengthened Euro provides an opportunity for Italian companies to buy U.S. companies at a cheaper price. He argued that Italian companies need to expand beyond the domestic market to enhance their overall competitiveness. Buttiglione also observed that Italian exporters would benefit from the lower price, in Euro terms, of raw materials. Arrigo Sadun, Director General of the macroeconomic department of the Ministry of Economy and Finance, expects the overall effect of a stronger Euro will be positive. Sadun told us that the possible loss in export earnings and market share would be offset by the positive impact by the lower price of oil imports and raw materials.

18. (U) According to Stefano Siviero of the research department of the Bank of Italy, the Central Bank predicts that a stronger Euro versus the dollar will reduce export growth only by an estimated 0.1 percent over the period 2003-2005.

The impact on GDP growth

19. (U) A stronger Euro also is expected to affect GDP growth negatively by approximately 0.3 percent in the same period. An anticipated increase in imports accounts for most of the negative impact on GDP growth. If the Euro were to appreciate significantly more versus other major currencies besides the dollar, the impact would be larger. According to leading economists, if the Euro were to strengthen by another 10 percent or more vis--vis the Yen, the British Pound and others, export growth could decline by 2.7 percent in the period 2003-2005 and GDP growth by 1.3 percent, in the same period.

10. (U) On June 10, Istat released final GDP growth data, which showed a 0.1 percent decrease from the fourth quarter 2002 to the first quarter 2003, but a 0.8 percent increase from the first quarter 2002. According to ISAE, Italian consumer confidence is the lowest in 9 years. Inflation fell from April to May, from 2.7 percent to 2.6 percent.

11. (U) The consensus forecast continues to estimate a GDP growth rate of one percent for 2003. However, a contact at the Central Bank mentioned to us that a recent Bank of Italy confidential report predicted a GDP growth rate of just 0.4 percent, the same as in 2002.

Other concerns

12. (U) The Euro's appreciation versus the dollar is just one factor constraining Italian exporters. Another important factor is the weakness of the German economy. Germany is Italy's largest trading partner, accounting for almost 20 percent of total Italian exports. An additional factor is the impact of SARS on consumer demand in Asia during the second and likely third quarter of this year. China, Japan and other Asian countries account for almost 7 percent of Italian exports. The combination of these factors is likely to reverberate

negatively on Italian exports and on Italian GDP growth this year.

Comment

113. (U) Exports account for about 25 percent of GDP and are one of the pillars of Italian economic growth. While exports have traditionally been vulnerable to exchange rate fluctuations, Italian exporters also are losing a competitive edge, many economists worry. Italy invests only .75 of its GDP percent in R&D, compared to an average of 1.75 percent of the EU. This lack of investment in technology, according to economists, has reduced the competitiveness of Italy exports and aggravated their sensitivity to exchange rate fluctuations. End-comment

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